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A Theoretical Analysis of Professional Partnership Goodwill

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The existence and ownership of the "goodwill" of professional partnerships¹ is one of the most muddled subjects in partnership law. Courts employ different definitions of goodwill and reach disparate results. Most importantly, they have held that professional partnerships have little goodwill available for distribution to withdrawing partners or deceased partners' estates,² but substantial goodwill for purposes of distributions to spouses in marital dissolutions.³

This Article concludes that the accounting concept of goodwill does not help identify the rights of withdrawing partners or partners' spouses in professional partnerships. The central problem is the difficulty of separating what is owned by such firms from the human capital owned by the partners individually. The accounting concept leads to a blind alley in terms of valuation and does not make sense of the case law.

The Article substitutes for the accounting approach a theoretical analysis of the partners' rights that views the rights of withdrawing partners in terms of optimal default compensation rules. It leads to the conclusion that withdrawing partners should not have a default property right in expected cash flows of the firm analogous to what has been characterized as "goodwill." On the other hand, broader rights of partners' divorced spouses may be justified by considerations applicable specifically to the divorce setting.

The Article proceeds as follows. Part I describes and explains the conventional accounting concept of goodwill. It shows that this concept contributes little to a determination of rights in professional partnerships because partnership goodwill is impossible to value in this context. Moreover, Part II shows how both the partner withdrawal and divorce cases have departed significantly and in different ways from the conventional meaning of goodwill. The remainder of the Article applies economic analysis to issues regarding the goodwill of professional partnerships. Part III analyzes the property rights of withdrawing partners, while Part IV articulates the different considerations that apply to the rights of partners' spouses in marital dissolutions.

1. This term is used here to refer to partnerships whose cash flows are produced primarily by the human capital of their members, as distinguished from financial capital such as inventory, real estate and manufacturing facilities. Thus, the term includes not only medical, law, architecture and accounting firms, but any personal-service-oriented business.

2. See *infra* note 45-46.

3. See *infra* text accompanying notes 58-74.

I. DEFINITION AND VALUATION OF GOODWILL

This Part describes the conventional meaning of goodwill as applied to professional partnerships. Section A states and analyzes the accepted definition of goodwill, while section B examines the appropriate way to value the goodwill of professional partnerships.

A. The Definition of Goodwill

This section states the conventional accounting meaning of goodwill, articulates the economic basis of this definition, and introduces the important subject of how and why legal meanings may differ from accounting conventions.

1. Accounting Definition in General

Accountants define goodwill as "excess" value that cannot be attributed to specific tangible and intangible assets.⁴ This value can be determined by assigning values to specific assets and subtracting these from the actual value of the firm, perhaps based on capitalizing the firm's earnings.⁵ Largely because of its highly subjective nature, goodwill is not accounted for on a company's balance sheet unless the company has established its value by purchasing it.⁶

The accounting definition is stated largely in terms of valuation.⁷ The economic reasoning underlying the accounting valuation is that goodwill represents the extra value or "synergy" arising from joint use of assets in a firm.⁸ It includes, for example, economies of scale resulting from combining plant capacity, efficient organization of productive assets, and the reduction in contracting costs from owning important assets rather than contracting for their use.⁹ Perhaps most impor-

4. See Rev. Rul. 59-60, 1959-1 C.B. 237, 241; DISCUSSION MEMORANDUM ON ACCOUNTING FOR BUSINESS COMBINATIONS AND PURCHASED INTANGIBLES 47-51 (Fin. Accounting Standards Bd. 1976); S. DAVIDSON & R. WEIL, HANDBOOK OF MODERN ACCOUNTING 21-27 (2d ed. 1977); T. FIFLIS, H. KRIPKE & P. FOSTER, ACCOUNTING FOR BUSINESS LAWYERS: TEACHING MATERIALS 262-65 (3d ed. 1984); 1 L. SEIDLER & D. CARMICHAEL, ACCOUNTANT'S HANDBOOK § 23, at 5 (6th ed. 1981); R. KAY & G. SEARFOSS, HANDBOOK OF ACCOUNTING AND AUDITING 23-28 (1988).

5. Capitalized earnings valuation is discussed in subsection I.B.2.

6. See S. DAVIDSON & R. WEIL, *supra* note 4, at 21-15; R. KAY & G. SEARFOSS, *supra* note 4, at 23-33; 1 L. SEIDLER & D. CARMICHAEL, *supra* note 4, § 23, at 33. However, goodwill is only part of the difference between the firm's balance sheet net worth and its market value. Another unrecorded element of market value is the difference between the depreciated historical cost and current value of recorded assets. See T. FIFLIS, H. KRIPKE & P. FOSTER, *supra* note 4, at 634-73.

7. See Parkman, *The Treatment of Professional Goodwill in Divorce Proceedings*, 18 FAM. L.Q. 213, 213 (1984).

8. This is closely related to the "team production" concept of the firm. See *infra* text accompanying notes 78-79.

9. For example, a firm can cut costs by purchasing an important source of supply and thereby eliminating the possibility that a separate owner will attempt to ex-

tantly in professional firms, goodwill arises from the application of management and monitoring to other inputs such as employees and equipment.

Goodwill should be distinguished from the category of "intangible," or non-physical, assets. Goodwill can inhere in even the most "tangible" asset to the extent that the asset has extra value in conjunction with other assets. For example, the firm may derive value from skillfully using its equipment or exploiting its location. Moreover, even to the extent that goodwill can be considered intangible or non-physical, it is only a subcategory of intangible assets. Some intangibles such as patents have value even apart from their use in conjunction with other assets. Accordingly, such intangibles are not properly characterized as goodwill in themselves, although they may have extra synergy value that is includable in the general goodwill of the firm. By contrast, a firm's trade name is largely "goodwill" because it is identified with the firm's general reputation, which in turn results from, among other things, the extra value produced by the assets in place.¹⁰

2. "Firm" vs. "Personal" Goodwill

In valuing professional partnerships it is important to separate goodwill that is property of the firm (referred to here as "firm goodwill") from the reputations of partners and other partnership employees that are not partnership property ("personal goodwill"). Cash flows produced by a firm are almost always associated to some extent with the people who provide managerial, monitoring and other skills, or whose reputations may attract customers. The compensation these people receive for their efforts is their own property, or "personal

plot its advantage by raising the price. See Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

10. Thus, one or more partners may be precluded from using a partnership's trade name in order to avoid deceiving the public, which relies on the reputation of the firm as a whole that is signalled by the trade name. See *Messer v. The Fadettes*, 168 Mass. 140, 46 N.E. 407 (1897); *Bailey v. Betti*, 241 N.Y. 22, 148 N.E. 776 (1925); *Bailey v. Betti*, 126 Misc. 45, 212 N.Y.S. 455 (1925); *Siddall v. Keating*, 8 A.D.2d 44, 185 N.Y.S.2d 630 (1959), *aff'd*, 7 N.Y.2d 846, 196 N.Y.S.2d 896, 164 N.E.2d 860 (1959); *Blakely v. Sousa*, 197 Pa. 305, 47 A. 286 (1900); MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 2-11 (1983)[hereinafter MODEL CODE]; MODEL RULES OF PROFESSIONAL CONDUCT Rule 7.5 (1989)[hereinafter MODEL RULES]; 2 A. BROMBERG & L. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 7.12(a), at 7:110 (1988)[hereinafter BROMBERG & RIBSTEIN]. Even when the partners do have the right to use the partnership's name, they may have to account to their co-partners for profits derived from this use of the firm's reputation. See *Richter v. Richter*, 202 Ga. 554, 43 S.E.2d 635 (1947); *Estate of Spingarn*, 5 Misc. 2d 36, 159 N.Y.S.2d 532 (1956); 2 BROMBERG & RIBSTEIN, *supra*, § 7.12(b)(1), at 7:111.

goodwill." Any residual attributed to these efforts but not paid as compensation is part of the equity holders' interests.

Even partnerships that rely on the partners' skills or reputations rather than financial capital potentially have firm goodwill. First, the compensation of partners and other employees is based to some extent on the market for their services. Partners' human capital may be firm-specific in the sense that it has greater value to their current firm than to other firms.¹¹ If so, the partner may not be able to bargain for compensation equalling the full value of her services to the firm.¹²

Second, the partners' value to the firm may be inseparable from value added by combining the partners' services with other human and financial resources. For example, partners and other employees may work harder or more efficiently because of monitoring by partners.¹³ In other words, there is a synergy between monitoring and the partners' personal goodwill. Because the two cannot be separated precisely, the partners' residual claim may include earnings attributable partly to personal skills or reputations of other partners.

The distinction between personal and firm goodwill thus turns on partners' compensation for services, which determines the extent of the partners' residual claims. It does not turn, as some commentators believe,¹⁴ on whether a firm's value is attributed to particular partners' reputations, or on whether those partners can withdraw and take their reputations with them. As long as the partners are associated with the firm some of the earnings attributed to them may be part of the other partners' ownership interests.¹⁵

11. See *infra* text accompanying notes 95-96 (discussing firm-specific human capital and its role in determining partner compensation).

12. This does not mean, however, that the partner's compensation necessarily is limited to the value of the services to other firms. The partner may have negotiating leverage because her services are uniquely valuable to the other partners. Moreover, the other partners may agree *ex ante* to compensate for the full value of firm-specific skills in order to encourage the partner to develop such skills. See *infra* text accompanying notes 95-96.

13. See 2 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 25.05[1], at 23-65 (1988)(goodwill may include efficient exploitation of salaried workers). In large law practices, goodwill may be attributable to partners' profits from associates' efforts. See Friedman, *Professional Practice Goodwill: An Abused Value Concept*, 2 J. ACAD. MATRIMONIAL LAW. 23, 30 (1986). These profits may be at least partly explained by the synergy of partners' monitoring and training and the associates' human capital.

14. See, e.g., Parkman, *supra* note 7, at 214-15:

To the extent that a business is more profitable than its competitors because of the superior abilities or business connections of an individual, the profits are attributable to the individual, not the business. The individual should be able to capture the higher profits in higher wages or will move to a competitor.

15. The dependence of partnership earnings on particular partners' reputations is, however, relevant to the distinction between firm and personal goodwill. The more earnings can be identified to particular partners, the more likely it is that

3. *Legal vs. Accounting Definitions*

The legal definition of goodwill may differ from both the accounting and economic meanings. To some extent this seems attributable simply to the economic ignorance of courts and legal commentators. For example, a venerable and often-quoted definition of goodwill is "nothing more than the probability that the old customers will resort to the old place."¹⁶ This differs from the accounting definition of goodwill in at least two respects. First, it refers only to the particular aspect of goodwill comprised of favorable relationships with customers. In other words, it focuses solely on revenue, and excludes consideration of the firm's extra profitability on the cost side arising from, for example, favorable relationships with suppliers and creditors,¹⁷ or from any joint use of assets that produces cost-savings irrespective of the firm's reputation. Second, this definition includes non-goodwill elements of value associated with particular assets such as location rather than synergistic use of assets.

The legal definition of goodwill may differ from accounting and economic meanings not only by indirection, but also because the context of the legal determination matters. For example, one court characterized a patent as "goodwill" in order to penalize a wrongfully withdrawing partner.¹⁸ Another court, in order to effectuate the parties' intent in a close corporation buy-sell agreement, held that "book value" included goodwill despite contrary expert accounting testimony.¹⁹

As discussed below,²⁰ the legal context is clearly important in connection with determining professional partnership goodwill in divorce cases. The importance of context indicates that factors other than the accounting definition, perhaps including those discussed below in Parts III and IV, have a role in shaping the case law.

4. *Summary*

From an accounting standpoint, partnership assets can be sepa-

those partners will be in a position to negotiate to be paid for their full contributions to the firm. Furthermore, the expected value of cash flows linked to particular partners turns on the likelihood those partners will remain with the firm. This can depend on such things as the existence of restrictive non-competition agreements that bind the partners to the firm.

16. *Crutwell v. Lye*, 17 Ves. 335, 346, 34 Eng. Rep 129, 134 (Ch. 1810).

17. See 2 BROMBERG & RIBSTEIN, *supra* note 10, § 7.13(c), at 7:124-7:125.

18. See *Pav-Saver Corp. v. Vasso Corp.*, 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986). As goodwill, the value of the patent would not be distributable to the wrongful partner under the UNIF. PARTNERSHIP ACT § 38(2), 6 U.L.A. 1, 456-57 (1969)[hereinafter U.P.A.].

19. See *Piedmont Publishing Co. v. Rogers*, 193 Cal. App. 2d 171, 14 Cal. Rptr. 133 (1961).

20. See *infra* Part IV.

rated into the following categories: (1) tangible or physical assets, such as furniture, books and machines; (2) intangible assets such as patents and copyrights that can be valued discretely; and (3) "goodwill" that arises from the particular firm's synergistic combination of tangible and intangible assets. In a professional firm, it is necessary to distinguish both specific firm assets and firm goodwill from human capital owned by the individual partners. As discussed in section B, this distinction presents formidable valuation problems.

B. Valuation of Goodwill

This section will discuss methods of valuing partnership goodwill in the light of the analysis in section A.

1. *Market Value*

One way to value partnership goodwill is to examine amounts actually paid on account of goodwill (1) by purchasers of the firm; (2) by purchasers of comparable firms; or (3) to individual, withdrawing partners in the same or comparable firms.²¹

There are several potential problems with applying this approach to professional firms. First, in light of the personal nature of professional firms, it may be difficult to determine whether firms being used for valuation are comparable to the firm being valued.

A second problem with market valuation is that it may be difficult to determine the extent to which the price represented payment for partnership goodwill. If the seller has agreed to recommend or to refrain from competing with the buyer, payment to the seller represents at least partly payment for the partner's post-withdrawal cooperation rather than on account of the partner's ownership interest in the firm.²²

2. *The Capitalized Earnings Approach*

If there is no basis for a market valuation, the parties or court may use the conventional "capitalized earnings" approach. This method produces a substitute market price by considering how hypothetical buyers and sellers might determine the firm's investment value.

The capitalized earnings approach determines the firm's expected future returns and fixes an asset value by applying a "capitalizer" to those expected returns. The value of expected future returns is commonly determined by averaging earnings over the five or so most recent years. The "capitalizer" is the product of the formula $V = c \times e$,

21. See Rev. Rul. 59-60, 1959-1 C.B. 237, 242.

22. Cf. *In re Estate of McCubbin*, 125 Ill. App. 3d 74, 465 N.E.2d 672 (1984) (estate of deceased physician did not include value of sole practice; the court distinguished cases involving covenants not to compete as not involving firm goodwill).

where V is the value of the investment, e is the expected earnings and c is the capitalizer. The capitalizer reflects both the risk associated with the investment and expected growth. Thus, a high capitalizer means that the investment is relatively low risk or has a high expected rate of growth, or some combination of the two.²³

The capitalizer conventionally is derived from the stock price of similar publicly traded firms. Since law, accounting or other professional firms do not have publicly traded analogues, the courts must substitute some guesswork. For example, in *Dugan v. Dugan*,²⁴ the court, in valuing a sole law practice in a divorce case, said that it was important to consider the likelihood of repeat patronage and the husband's immunity from competition in comparison with other lawyers. The court said the evidence did not support the expert's use of a capitalizer of five.

Applying the capitalized earnings approach produces a going concern value for professional firms that includes what is commonly characterized as goodwill. Each partner would be entitled to share in this value on dissolution of the firm in accordance with the Uniform Partnership Act (U.P.A.) or the parties' agreement.²⁵ If the partnership business continued after partner dissociation, the leaving partner would, in effect, sell her interest in the goodwill to the other partners.

Use of the capitalized earnings approach theoretically is not precluded in professional firms by the fact that the firm's expected earnings are substantially attributable to the partners' skills and reputations. Consistent with the conventional meaning of goodwill, this expectation is a component of the partnership's assets to the extent that there is a residual remaining after the partners are compensated for their services.²⁶

Nor is the capitalized earnings method necessarily inapplicable because the firm's continuity is constantly threatened by potential partner withdrawal. If the partnership is being valued in connection with a partner's withdrawal, expected earnings must be determined without the component of those earnings attributed to the withdrawing partner. While the remaining partners technically have the power and right to withdraw and to take business with them,²⁷ they may be bound to the firm by non-competition agreements²⁸ or because of the structure of withdrawal compensation.²⁹ Moreover, the risk of key

23. See R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 56-61 (3d ed. 1988).

24. 92 N.J. 423, 457 A.2d 1 (1983).

25. See *infra* text accompanying notes 39-43.

26. See *supra* subsection I.A.2.

27. See *Fraser v. Bogucki*, 203 Cal. App. 3d 604, 250 Cal. Rptr. 41 (1988) (denying law partner's claim against former partners for appropriation of client relationships).

28. See 2 BROMBERG & RIBSTEIN, *supra* note 10, § 7.12(b)(2).

29. See *infra* text accompanying notes 118-120 (amount of withdrawal compensation

partners' withdrawal can be taken into account in selecting the capitalizer.

This is no different from market valuation of publicly traded non-professional firms. The market value of many conventional non-professional corporations is significantly determined by the talents of their personnel, including dynamic chief executives, innovative researchers and the like, who are not irrevocably bound to the firm.³⁰ That is why market price may rise or fall in the event of personnel changes.³¹

3. *Problems With Applying Capitalized Earnings Valuation to Professional Firms*

Although capitalized earnings valuation is theoretically appropriate for professional firms, its application should be qualified in the latter context because of an important difference between professional partnerships and non-professional firms. The earnings used to calculate the non-professional firm's investment value are computed after deducting all expenses, *including* executive compensation. However, in professional partnerships, the partners receive profit shares that reflect compensation for both their human capital and financial contributions. In order to determine a value for a professional partnership that is equivalent to that of a comparable non-professional firm, it is necessary to subtract from total partnership cash flows the capitalized value of compensation for the partners' human capital contributions.³²

It follows that applying the capitalized earnings approach to pro-

may be set to deter opportunistic withdrawal); *Antolik v. Harvey*, 761 P.2d 305 (Haw. App. 1988)(questioning refusal to apply capitalized earnings approach to valuation of goodwill where the firm has the legal right to partners' continued services or non-competition).

30. It is true that chief executive officers often can negotiate for compensation that equals or exceeds their contributions to the firm's value. That is because they bargain with friendly boards of directors, and because the shareholders' costs of disciplining overcompensation through such devices as proxy contests or tender offers often exceeds the amount of the overcompensation. This observation is supported by evidence that the death of chief executives can increase the firm's market value. See Johnson, Magee, Nagarajan & Newman, *An Analysis of the Stock Price Reaction to Sudden Executive Deaths*, 7 J. ACCT. & ECON. 151 (1985). There is also evidence that top executive compensation is affected only slightly by firm performance. See Jensen & Murphy, *Performance Pay and Top Management Incentives*, 98 J. POL. ECON. 225 (1990). However, these considerations may not apply to lower-level executives who have less leverage in negotiating their compensation, and whose separate personal contributions are more difficult to identify. See Coffee, *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435.
31. For evidence that death of chief executives can positively or negatively influence firm value, see Johnson, Magee, Nagarajan & Newman, *supra* note 30.
32. See *supra* subsection I.A.2 ("firm goodwill" is amount remaining after subtracting partner compensation representing "personal goodwill").

fessional firms may overvalue goodwill. Indeed, in small law or medical practices, there may be little that can be characterized as an ownership interest because the partners probably will be paid virtually all of the net revenues as compensation for their human capital contributions.³³ Thus, at least most of a partner's compensation is attributable to "personal goodwill." To put this another way, a non-partner or inactive partner would receive very little on account of an ownership interest in a small professional firm.³⁴

The problem, therefore, in using the capitalized earnings approach in the professional firm context is that it may be impossible to separate a professional partner's ownership interest in the firm from the partner's income as an employee. Theoretically, this could be done by determining the partners' comparable compensation outside the firm.³⁵ However, for several reasons this is impractical. First, it is prohibitively difficult to establish comparability among professionals because their talents and specialties are so varied.

Second, even a comparable professional's salary cannot be used as a standard because the salary is a function of circumstances different from those that apply in the partnership. In particular, the professional may accept a lower salary in a corporation in exchange for bearing less risk in terms of job insecurity and income variability,³⁶ or in exchange for a higher level of shirking.³⁷

Third, even if the partner's pay opportunity outside the firm is known, this does not necessarily limit the partner's compensation in the firm because the partner's services may be more valuable in the firm, and the partner may be able to negotiate to be paid this extra value.³⁸

In short, the accounting concept of professional partnership goodwill presents serious valuation problems. Comparable market values are often unavailable, and attempting to substitute capitalized earnings valuation presents insuperable problems. For this reason alone, some alternative method must be found for determining partners'

33. *Id.*

34. By contrast, in a larger practice there may be substantial earnings from relatively anonymous employees, technical equipment, monitoring and organization that is not distributed as compensation to particular employees. Thus, advertising agencies and brokerage firms have publicly traded stock despite their professional nature. Even an accounting firm reportedly has arranged to go public. See Cowan, *C.P.A.'s to Sell Stock in Practice*, N.Y. Times, June 14, 1990, at D7, col. 4.

35. See Gilson & Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 354 (1985).

36. See Friedman, *supra* note 13, at 27; Parkman, *supra* note 7, at 221.

37. See Dugan v. Dugan, 92 N.J. 423, 457 A.2d 1 (1983)(excluding from goodwill any extra compensation to a professional partner attributable to expending greater effort).

38. See *supra* note 12.

rights. As discussed in the following three sections, the confusion in the case law and the policies regarding partner compensation and the rights of partners' spouses provide additional reasons.

II. THE LAW OF PARTNERSHIP GOODWILL

This Part discusses how the courts have approached professional partnership "goodwill" in determining the rights of partners on withdrawal from the firm, and of partners' spouses in marital dissolutions. It shows that these cases differ both from each other and from the conventional accounting concept of goodwill discussed in Part II.

A. Denial of Right to Share in Goodwill on Dissolution

The U.P.A. defines the parties' rights on dissolution of a partnership in the absence of contrary agreement. The partnership dissolves on any dissociation of a partner from the partnership,³⁹ including death, expression of will to dissolve the relationship, and withdrawal.⁴⁰ If the dissolution is not in contravention or otherwise wrongful, as where there is an unexpired term or uncompleted undertaking, the partnership assets must be sold and debts paid unless all of the partners, including the withdrawing partner, agree to continuation of the partnership and a payoff of the withdrawing partner.⁴¹ In the event of a continuation, the dissociating partner is paid the value of her interest.⁴² If the dissolution was wrongful, the non-wrongful partners may agree to continue the firm and pay the wrongful partner the value of her interest less damages and excluding goodwill.⁴³

Under these provisions, the issue of goodwill may arise whenever the partnership is continued after withdrawal of a non-wrongfully dissolving partner,⁴⁴ when it is necessary under the U.P.A. to determine the "value" of the dissociating partner's interest in the partnership.

The cases hold that a withdrawing partner is entitled only to elements of value related to such things as location or organization, and

39. See U.P.A. § 31, 6 U.L.A. 1, 376-77 (1969).

40. Partner withdrawal is part of the definition of partnership under section 29 of U.P.A., although it is not listed among the dissolution causes in section 31. For cases holding that partner withdrawal causes dissolution, see, e.g., *Great Hawaiian Fin. Corp. v. Aiu*, 863 F.2d 617 (9th Cir. 1988) (applying Hawaiian law); *Ramseyer v. Ramseyer*, 98 Idaho 47, 558 P.2d 76 (1976); *Schoeller v. Schoeller*, 465 S.W.2d 648 (Mo. Ct. App. 1971).

41. See U.P.A. § 38, 6 U.L.A. 1, 456-57 (1969).

42. *Id.* § 42, 6 U.L.A. at 521.

43. *Id.* §§ 38(2), 42, 6 U.L.A. at 456, 521.

44. Technically the partnership may be sold as a going concern in a liquidation under section 38(1) of the U.P.A. However, in the case of a professional firm, the principal assets of which are the partners' human capital, it is highly unlikely that there will be any sale other than to the dissolving partners, which is the same in effect as an agreed continuation of the partnership.

not those related to the reputations of individual partners.⁴⁵ This rule is reinforced by cases holding that where a departing professional partner is paid for "goodwill," this implies that the partner actually has been paid not to compete with the firm.⁴⁶

An important, illustrative case is *In re Brown*.⁴⁷ The court held that the executors of a deceased partner's estate could not be surcharged for acquiescing to continuation of a stock brokerage partnership without payment for goodwill to partner's estate. The court applied the conventional legal definition of goodwill as the expectancy of future patronage.⁴⁸ The test was whether a third-party purchaser of the business would have paid the original partners anything for goodwill.

The court said there may have been some slight value attributable to "continuity of place," since some customers might wander by even after the sale to third parties. But this was relevant only to one branch of the business because the other branches were conducted on the floor of the stock exchange by particular people and not at the firm's principal place of business. The only other potential elements of value were "continuity of organization," which the court said would be negligible for such a simple business, and "continuity of name," which in this case would consist only of such advantage as the new owners could get from doing business as the "successor" to the former firm. In short, the estate was entitled to nothing associated with the reputations of the individual partners.

Brown's reasoning is inconsistent with the conventional concept of goodwill discussed in Part I. The firm's value actually consists of all elements that produce the firm's earnings, including the partners' rep-

45. For cases recognizing the existence of good will based on factors other than the partners' reputation, see *Craver v. Nakagama*, 94 N.C. App. 158, 379 S.E.2d 658, *appeal denied*, 325 N.C. 270, 384 S.E.2d 514 (1989)(name of partnership's funeral home was asset for value of which continuing partners must account); *Schoen v. J.C. Bradford & Co.*, 642 S.W.2d 420, 425 (Tenn. Ct. App. 1982)(goodwill of brokerage firm attributable to "value of assets 'in place,' 'assembled,' for use by a going concern, and not as separate items"); *Berg v. Settle*, 70 Wash. App. 684, 425 P.2d 635 (1967)(income generated from X-ray equipment). See also *Spaulding v. Benenate*, 57 N.Y.2d 418, 456 N.Y.S.2d 733, 442 N.E.2d 1244 (1982)(goodwill based on location in sole practice). Note that these cases mistakenly attribute "goodwill" to specific assets. See *supra* text following note 17.

For authorities holding that goodwill associated with the particular partners is not property of a professional partnership, see *Siddall v. Keating*, 8 A.D.2d 44, 185 N.Y.S.2d 630 (1950), *aff'd*, 7 N.Y.2d 846, 196 N.Y.S.2d 986, 164 N.E.2d 860 (1959); *Jackson v. Caldwell*, 18 Utah 2d 81, 415 P.2d 667 (1966); Laube, *Good Will in Professional Partnerships*, 12 CORNELL L.Q. 303 (1927).

46. See *Brown v. Benzinger*, 118 Md. 29, 84 A. 632 (1912); *Mohawk Maintenance Co. v. Kessler*, 52 N.Y.2d 276, 437 N.Y.S.2d 646, 419 N.E.2d 324 (1981); *Crane, Partnership Goodwill*, 18 VA. L. REV. 651, 656-57 (1932).

47. 242 N.Y. 1, 150 N.E. 581 (1926).

48. See *supra* text accompanying note 16.

utations. In other words, merely because goodwill is associated with individual partners, it is not necessarily personal goodwill.⁴⁹ That a third party purchasing the firm from the partners would not acquire elements of value attributable to the partners personally is true but irrelevant. *Brown* involved the valuation of a single deceased partner's interest. While this partner's death may have affected the value of the firm,⁵⁰ the firm was basically intact and the interest was being purchased by the continuing partners.

Brown makes more sense in light of the fact that partner compensation must be subtracted in determining firm goodwill.⁵¹ In a small partnership like the one involved in *Brown*, perhaps the partners are being compensated fully for their human capital contributions. If so, no value attributable to the partners' efforts is firm goodwill. In *Brown* the deceased had been receiving fifteen percent of the profits prior to his death without rendering any services. This percentage could have been either a form of deferred compensation for earlier services or an indication of the partners' ownership interests derived, for example, from organization, location, or monitoring of non-partner employees.

Except to the extent the courts are precluded by ethical rules governing lawyers,⁵² the default rule applied in *Brown* can be overridden by express or implied agreement,⁵³ as where the partners agreed to a purchase price for goodwill.⁵⁴ Thus, the principal question in this context is whether the denial of professional partnership goodwill is a suitable default rule.

Although the cases generally hold that professional partnerships do not own goodwill in the sense of the partners' reputations, withdrawing professional partners have been held entitled to share in fees for "work-in-process," including legal cases begun prior to dissolution and completed and paid for afterward.⁵⁵ Except after a partner's death, the partners are paid on the same basis as if the partnership had

49. See *supra* subsection I.A.2.

50. In fact, the effect was minimal because the partner had been inactive for years prior to his death, which was reflected in a reduction of his interest.

51. See *supra* text accompanying note 32.

52. See *infra* section III.F.

53. In fact, it is not clear in *Brown* whether the court was applying a default rule or a custom agreement. The court pointed out that incoming members paid nothing for goodwill, and that a partner had retired without being paid for goodwill. *In re Brown*, 242 N.Y. 1, 11, 150 N.E. 581, 584 (1926).

54. See *Stefanski v. Gonnella*, 15 Mass. App. Ct. 500, 446 N.E.2d 734 (1983). A partner may also be entitled to payment for agreeing not to compete. See *Evans v. Gurnip*, 36 Del. Ch. 589, 135 A.2d 128 (1957). See also *supra* text accompanying note 46 (non-competition agreement implied from "goodwill" payment).

55. See *Jewel v. Boxer*, 151 Cal. App. 3d 171, 199 Cal. Rptr. 273, *modified*, 156 Cal. App. 3d 178, 203 Cal. Rptr. 13 (1984); *Fox v. Abrams*, 163 Cal. App. 3d 610, 210 Cal. Rptr. 260 (1985); *Ellerby v. Spiezer*, 138 Ill. App. 3d 77, 485 N.E.2d 413 (1985).

not dissolved, without any credit for extra work done by the completing partners.⁵⁶ Like future business from the same client, or from other clients attracted by the firm's reputation, the fee from work-in-process is only an expectation at the time of dissolution contingent on the client's choosing not to discharge the firm. Thus, it is not clear why the courts do not treat work-in-process like goodwill.

B. Partnership Goodwill in Divorce Cases

A partner's spouse often claims that partnership goodwill is an asset eligible for equitable distribution on divorce. The law on this issue is rapidly developing and the courts have reached divergent results. Many divorce cases clearly refuse to make a property award based on personal goodwill.⁵⁷

Analysis of the remaining cases is complicated by the fact that the courts often conclude that goodwill exists without precisely defining or attempting to value it.⁵⁸ The cases that have recognized the existence of goodwill in professional partnerships⁵⁹ are not necessarily inconsistent either with the conventional concept of goodwill or with

56. See U.P.A. § 18(f), 6 U.L.A. 1, 213 (1969).

57. For cases excluding any goodwill arising out of the professionals' personal reputations, see *Powell v. Powell*, 231 Kan. 456, 648 P.2d 218 (1982); *Depner v. Depner*, 478 So. 2d 532 (La. Ct. App. 1985); *De Masi v. De Masi*, 366 Pa. Super. 19, 530 A.2d 871 (1987); *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972); *Hirsch v. Hirsch*, 770 S.W.2d 674 (Mo. App. 1989) (goodwill excludes value of non-competition agreement).

Other cases reach substantially the same result by accepting as evidence of value only the market value of the practice if sold by the professionals. A leading case is *Austin v. Austin*, 619 S.W.2d 290 (Tex. Civ. App. 1981) (spouse could share in the proceeds of the sale of a medical practice, in the absence of any evidence that part of the value was attributable to pre-marriage clients or to a non-competition agreement). For other cases, see *Wilson v. Wilson*, 294 Ark. 194, 741 S.W.2d 640 (1987); *Hanson v. Hanson*, 738 S.W.2d 429 (Tex. Civ. App. 1987). For a discussion of the problems of market valuation of good will, see text accompanying notes 21-22 above.

58. For a good example of such a case, see *Sorenson v. Sorenson*, 769 P.2d 820 (Utah 1989), in which the majority held, over a strong dissent, that the court could recognize the existence of goodwill even if it was difficult to value.

59. See *Mitchell v. Mitchell*, 152 Ariz. 317, 732 P.2d 208 (1987); *In re Marriage of Feinstein*, 17 Cal. 3d 738, 131 Cal. Rptr. 873, 552 P.2d 1169 (1976); *Golden v. Golden*, 270 Cal. App. 2d 401, 75 Cal. Rptr. 735 (1969); *In re Marriage of Foster*, 42 Cal. App. 3d 577, 117 Cal. Rptr. 49 (1974); *Mueller v. Mueller*, 144 Cal. App. 2d 245, 301 P.2d 90 (1956); *Bush v. Bush*, 191 Ill. App. 3d 249, 547 N.E.2d 590 (1989); *Ford v. Ford*, 782 P.2d 1304 (Nev. 1989); *Stern v. Stern*, 66 N.J. 340, 331 A.2d 257 (1975); *Weaver v. Weaver*, 72 N.C. App. 409, 324 S.E.2d 915 (1985); *Buckl v. Buckl*, 373 Pa. Super. 521 542 A.2d 55 (1988); *Sorenson v. Sorenson*, 769 P.2d 820 (Utah. 1989); Annotation, *Divorce and Separation: Goodwill in Medical or Dental Practice as Property Subject to Distribution on Dissolution of Marriage*, 76 A.L.R.4th 1025 (1990); Annotation, *Accountability for Goodwill of Professional Practice in Actions Arising from Divorce or Separation* 52 A.L.R.3d 1344 (1973); Annotation, *Evaluation of Interest in Law Firm or Medical Partnership for Purposes of Division of Property in Divorce Proceedings*, 74 A.L.R.3d 613 (1975).

partner withdrawal cases such as *Brown*.⁶⁰ There would also be no inconsistency if a court recognized the existence of goodwill attributable to the reputations of individual partners,⁶¹ since there may be some partnership goodwill arising out of the residual left after compensating the partners.⁶²

There is, however, evidence that at least some courts are willing to include in partnership goodwill value that would be considered personal goodwill under the conventional view. In these cases, partners' spouses have been awarded, under the guise of "partnership goodwill," amounts that are actually attributable to the value of the partners' human capital.⁶³

First, some cases recognize the existence of goodwill in sole practices, in which it is highly unlikely that any residual claim would remain after compensation of the professional owner.⁶⁴ Second, many divorce cases use the capitalized earnings approach for valuing partnership goodwill in a way that easily can result in giving the spouse an interest in personal goodwill. Under this approach, the partner spouse's goodwill interest is computed by (1) determining the partner's average compensation; (2) subtracting an annual return on the partnership's tangible assets and compensation for a professional comparable to the partner spouse; and (3) capitalizing the product to determine an asset value.⁶⁵

This approach is inconsistent with the conventional meaning of goodwill because it is based on the cash flows of a particular partner rather than those of the firm. A partner's actual profit percentage and

60. See *supra* text accompanying notes 47-48.

61. See, e.g., *Ford v. Ford*, 782 P.2d 1304 (Nev. 1989); *In re Marriage of Hall*, 103 Wash. 2d 236, 692 P.2d 175 (1984).

62. See *supra* subsection I.A.2.

63. For commentary recognizing this, see Friedman, *supra* note 13; Parkman, *supra* note 7.

64. See *Dugan v. Dugan*, 92 N.J. 423, 457 A.2d 1 (1983); *In re Marriage of Steinbrenner*, 60 Or. App. 106, 652 P.2d 845 (1982); *In re Marriage of Lukens*, 16 Wash. App. 481, 558 P.2d 279 (1976).

65. See *Dugan v. Dugan*, 92 N.J. 423, 457 A.2d 1 (1983); *Levy v. Levy*, 164 N.J. Super. 542, 397 A.2d 374 (1978); *In re Marriage of Hall*, 103 Wash. 2d 236, 692 P.2d 175 (1984); 2 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 23.05[2][b], at 23-67 to -69 (1988); Friedman, *supra* note 13; Kline, *Firm Valuation: Picking the Appropriate Formula*, Nat'l L.J., Jan. 15, 1990, at 15; Raggio, *Professional Goodwill and Professional Licenses as Property Subject to Distribution Upon Marriage*, 16 FAM. L.Q. 147 (1982); Warner, *Savey & Sailors, Theory and Evaluation of Business and Professional Good Will Upon Dissolution, Contest or General Sale in Washington State*, 23 GONZ. L. REV. 113 (1987). For a discussion of capitalization, see text accompanying note 23 above. The significant difference between a capitalized earnings approach and one relying on market valuation is indicated by *In re Marriage of Fortier*, 34 Cal. App. 3d 384, 109 Cal. Rptr. 915 (1973), in which the capitalized earnings value of \$294,000 was almost thirty times the market valuation.

her comparable compensation level may reflect the firm's allocation of total *compensation* dollars among the partners rather than partners' *asset* shares.⁶⁶ Unlike the residual between compensation and total cash flows that constitutes conventional goodwill, this "goodwill" does not necessarily result from the inability to separate out the individual's compensation and her ownership interest.⁶⁷ Rather, it may result from the firm's decision to reduce the partners' risk by disengaging their compensation from the fluctuating value of their human capital.⁶⁸ This difference from conventional goodwill is significant for the practical reason that the disparity between compensation levels and contributions to cash flow is likely to disappear over the long run. Thus, this approach may result in a spousal award that exaggerates a temporary health or market factor affecting the value of a partner's human capital.⁶⁹

Even aside from these differences from the conventional view of goodwill, application of the capitalized earnings approach inherently invites evaluators to make awards based on personal goodwill because they cannot derive the partners' actual compensation which must be subtracted from cash flows to determine partnership goodwill.⁷⁰ Because it is never clear which professionals or which salaries to use as comparables, a court may be tempted to look at *average* compensation levels.⁷¹ This approach inappropriately incorporates in *partnership* goodwill all value attributable to the partner's exceptional skills.⁷²

The concept of goodwill in the divorce cases is significantly broader not only than the conventional view, but also than that applied in the partner withdrawal cases. Those cases resolve doubts about the existence of personal goodwill by going to the other extreme of excluding any value attributable to the partners' skills and reputation.⁷³ The difference between the divorce and withdrawal cases is particularly clear in those divorce cases which let the non-partner spouse share in partnership goodwill even when the partnership agreement explicitly

66. Ironically, this means that the more mediocre partners are assigned the highest asset values. See Friedman, *supra* note 13, at 26.

67. See *supra* text accompanying notes 35-38.

68. Risk-bearing reasons for departing from incentive-based compensation will be discussed in section III.B below.

69. Even if this method determined only partnership goodwill, it may not accurately measure the share of an individual partner in that goodwill because a partner's share in the firm's assets may differ from her income percentage. For example, a new partner may receive a high income percentage but a relatively small withdrawable asset share. Part III discusses considerations applying to determination of withdrawing partners' asset shares.

70. See *supra* text accompanying notes 35-38.

71. See Dugan v. Dugan, 92 N.J. 423, 457 A.2d 1 (1983).

72. See Friedman, *supra* note 13, at 27.

73. See *supra* text accompanying notes 45-51.

denies the partner such an interest on withdrawal from the firm.⁷⁴

The differences between the conventional concept of goodwill and the rules applied in the partner withdrawal and divorce cases raise the question whether factors other than the accounting concept of goodwill explain the legal rules. The following two Parts identify alternative considerations that may be operating in these cases.

III. A POLICY ANALYSIS OF COMPENSATION OF PROFESSIONAL PARTNERS

Parts I and II show that the conventional accounting approach to valuing professional partnership goodwill leads to a blind alley in terms of valuation and fails to explain the legal rules governing withdrawing partners and partners' spouses. This Part discusses an alternative method of determining the partners' rights to partnership goodwill.⁷⁵ Courts should view the professional firm, like other firms, as a nexus of contracts between the partners and others as factors of production.⁷⁶ Under this view, the appropriate question is how the partners would define their property rights so as to minimize their total contracting costs.

The answer to this question turns on how to minimize the total of four different types of costs of doing business in the partnership that are discussed in this Part: shirking; risk-bearing costs; the costs of determining the parties' rights under the contract; and opportunism.

This Part will cover the effect of each type of cost both on partners' periodic payments as active members of the firm and payments to deceased, withdrawing or otherwise dissociating partners.⁷⁷ Although

74. See *Mitchell v. Mitchell*, 152 Ariz. 317, 732 P.2d 208 (1987); *Molloy v. Molloy*, 158 Ariz. 64, 761 P.2d 138 (Ariz. App. 1988); *In re Marriage of Slater*, 100 Cal. App. 3d 241, 160 Cal. Rptr. 686 (1979); *Keith v. Keith*, 763 S.W.2d 956 (Tex. Civ. App. 1989); *In re Marriage of Hall*, 103 Wash. 2d 236, 692 P.2d 175 (1984); *In re Marriage of Brooks*, 51 Wash. App. 882, 756 P.2d 161 (1988). But see *McCabe v. McCabe*, 543 A.2d 558 (1988) (disallowing wife amount for goodwill because not allowed to husband under law partnership agreement).

75. This Part of the Article provides a way to determine the partners' rights on withdrawal to the firm's value in excess of the value of specific assets—that is, what is conventionally termed “goodwill.” In addition to the rights described in this Part, the partners would also be entitled to return of their capital contributions and other rights to specific partnership assets.

76. Some important articles expressing this view include Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

77. For convenience, “withdrawing” as used below refers to partners dissociating by all methods, and not limited to voluntary withdrawal. However, as is discussed below in the text accompanying note 121, it may be appropriate to vary partners' rights according to the type of the dissociation.

this Article is concerned mainly with payments to withdrawing partners, it is necessary to discuss methods for determining periodic payments in order fully to understand the considerations relating to withdrawal payments.

A. Shirking

"Shirking" refers to the tendency of members of an organization to expend less effort than the amount that would maximize the parties' joint "profit"—that is, revenue less the cost of the effort. This section will show how partners' periodic and withdrawal compensation can be designed to minimize shirking.

1. Periodic Payments

To understand shirking and its role in determining partner compensation, it is helpful to begin with the Alchian-Demsetz theory that parties organize into firms in order to take advantage of the benefits of team production.⁷⁸ The typical professional partnership is a good illustration of this theory. Professionals join together in a firm at least partly⁷⁹ because their joint product exceeds what the partners could produce in separate firms. The extra joint product might result from partners' complementary strengths and weaknesses. For example, some law partners may be particularly good at producing new business while others are better at servicing the clients. Or a "full-service" firm combining partners with different specialties may be more attractive to some clients than "boutique" firms that can advise on only one or two of a client's problems. Even a firm offering only one specialty, such as litigation, may offer a better product to some clients than a sole practitioner because several lawyers are better than one for handling large cases, or because different skills are needed for different aspects of a single case. There are also team production benefits from inputs other than the professionals themselves, including secretaries and computers.

But there is an offsetting cost of team production. Because the firm's product is inherently the result of joint effort, it is costly or impossible precisely to measure the contribution of each team member. This measurement problem gives team members, including professional partners, the incentive to contribute less effort than they would if their contributions to the total could be measured accurately. In other words, the team members have the incentive to shirk.

Firms can minimize shirking and so increase productivity through

78. Alchian & Demsetz, *supra* note 76.

79. Other reasons include risk diversification. See *infra* text accompanying notes 99-108.

"monitors" who observe, reward and punish team members.⁸⁰ To ensure that the monitors do their jobs, they are rewarded by a share of "profits"—that is, what is left over after fixed payments to team members. The monitors can maximize their profit shares by minimizing shirking.

Professional partners act as monitors of the other contributors to the firm, ranging from suppliers of office products through secretaries to associates or other non-partner professionals.⁸¹ By keeping a watchful eye, the partners increase productivity and thereby their profit-shares. Among other things, the partners keep track of the number of hours other professionals work, based on the assumption that hours worked is directly correlated with productivity. Lawyers keep careful time records for billing purposes, and there is evidence that partners also use these records for monitoring purposes.⁸² Observation of time worked may be an approximate measure of the work of lower-level associates who are more equal in abilities and who do more routine work than partners.

Professional partners are themselves team members as well as monitors. Controlling shirking by the partners presents special problems because it is difficult to evaluate professionals' work simply by observing it. For example, one lawyer may quickly create an insightful legal theory or write a brilliant brief while another labors fruitlessly over legal research or less artful drafting. Thus, the costs of hiring specialized monitors are likely to exceed the benefits. As a result, the partners must observe each other.

The partners also can devise methods such as incentive compensation to constrain shirking. If the partners equally divide the profits, each has a significant incentive to shirk, particularly if there are many partners, because each partner's benefits from shirking will exceed her share of the reduction in total profits.⁸³ Shirking in professional firms can be reduced by compensating partners on the basis of each partner's contribution to the joint product of the firm.⁸⁴ The main problem with this approach is that it is difficult to calibrate profit

80. See Alchian & Demsetz, *supra* note 76, at 781-83.

81. For an empirical analysis of monitoring of non-professional inputs in law firms, see Leibowitz & Tollison, *Free Riding, Shirking, and Team Production in Legal Partnerships*, 18 ECON. INQUIRY 380 (1980).

82. See McChesney, *Team Production, Monitoring and Profit-Sharing in Law Firms: An Alternative Hypothesis*, 11 J. LEGAL STUD. 379 (1982). The evidence includes a high correlation between hours billed and compensation and the fact that associates, who have more incentive to shirk because they do not share profits, keep more complete time records than partners.

83. See Alchian & Demsetz, *supra* note 76, at 780.

84. For a similar conclusion as to top management compensation, see Jensen & Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

share to effort precisely because much of senior professionals' work cannot be readily evaluated.⁸⁵

Fred McChesney argues that, in law firms at least, partners' compensation is aligned with their most important contribution to firm *productivity*—the production of new business.⁸⁶ But it is very difficult to measure a partner's promotional contribution. A firm's ability to attract and retain business is a function not only of the partners' individual promotion efforts but also of the firm's general reputation. Reputation, in turn, rests on such factors as publicity, the quality of the partners' work and the firm's success in training and recruiting new partners. The importance of reputation to business promotion and the difficulty of measuring each partner's contribution to reputation means that it is impossible precisely to calibrate partners' profit participation to their business promotion. As a result, this form of compensation can perversely encourage partners to put too much effort into direct client contacts and insufficient effort into general reputation-building.⁸⁷

The difficulty of providing appropriate incentives for professional partners has led firms to experiment with different types of compensation schemes, incorporating various factors relating to partners' contributions to the firm.⁸⁸ Most systems, rather than attempting to compensate in terms of the partner's specific contribution in the preceding period, use the preceding period's performance as a basis for adjusting the partner's profit share for the next period.

85. See Gilson & Mnookin, *supra* note 35, at 348-50. This is also a problem with Jensen and Murphy's marginal product approach to compensation in the chief executive officer context: it is very difficult to isolate the contribution of the chief executive officer from those of other team members. See Jensen & Murphy, *supra* note 84.

86. See McChesney, *supra* note 82.

87. See Hildebrandt, *Compensation for Partners—Problems with Formula Systems*, N.Y.L.J., Dec. 11, 1979, at 4, col. 1; Masters, *Economy Promotes Experiments with Profit-Splitting Methods*, Legal Times, Dec. 13, 1982, at 1, col. 3.

88. See, e.g., M. ALTMAN & R. WEIL, INTRODUCTION TO LAW PRACTICE MANAGEMENT §§ 5.01-15 (1987); Basile & Sandbach, *Practical Aspects to Implementing the Profit Center Concept of Income Distribution*, 7 LEGAL ECON., May-June 1981, at 37; Cantor, *Dividing Firm Income in the 1980s*, 23 LAW OFFICE ECON. & MGMT. 191 (1982); Heintz, *New Trends in Partner Profit Distribution*, 55 WIS. B. BULL., Oct. 1982, at 24 (identifying relevant factors in designing profit distribution system); Lyons, *Baker & McKenzie, The Belittled Giant*, AM. LAW., Oct. 1985, at 118 (partners of largest law firm in United States receive 75% of collected billings for their own work; 12% of billings originated by partner and a share of remaining net income divided by "points" determined by partner seniority); Rachlin, *Evaluating and Rewarding Partners*, 2 LEGAL ECON., Fall 1976, at 12 (explaining "three-tier" profit distribution system based on a combination of salary, points, and equal sharing); Rose, *A Plan for Distributing Profits of Law Firm*, N.Y.L.J., June 25, 1985, at 4, col. 1; Stille, *Turning to Two-Tier Partnerships*, Nat'l L.J., Oct. 22, 1984, at 14, col. 1.

No system so perfectly calibrates rewards that it can prevent partner shirking. Indeed, even the most perfectly calibrated compensation system would not eliminate shirking. Professional firms tend to be larger than other partnerships,⁸⁹ which means that there are many monitors and team members and therefore a greater possibility that each will free-ride on the efforts of others.⁹⁰ A system that is perfectly calibrated to reward partner *productivity* may actually encourage shirking with regard to monitoring other inputs, since a partner with a relatively low profit share has even less incentive to control costs than one with a large profit share.⁹¹

Despite these problems with compensation design, it remains true that the closer the compensation system comes to paying the partners in terms of their contribution to the firm's product, the more that system will deter shirking.

Finally, it is important to note that incentive compensation is not the exclusive method of constraining shirking. First, the market for professionals' services fills a gap in the firm's compensation by providing ex post settling up.⁹² Second, shirking can be disciplined directly through expulsion. Third, if partners attempt to free-ride on the efforts of their co-partners, the hard-working co-partners can withdraw and seek other employment that will fully compensate their efforts. Of course, these devices are not perfect constraints. Because of difficulties of evaluating professionals' work, the employment market provides only rough settling up. Expulsion, because of its severe effect on the expelled partner, will only be provided for in the event of the most extreme forms of shirking. And the parties may wish to limit the right of exit because easy exit facilitates opportunistic conduct.⁹³ But these alternative constraints are relevant in evaluating whether the costs of incentive compensation discussed below in section B outweigh the costs of any additional shirking that would result from abandoning incentive compensation.

89. This may be partly because large firms facilitate diversification of human capital risks. See *infra* text accompanying notes 100-02.

90. See Leibowitz & Tollison, *supra* note 81 (showing how such free-riding increases the costs even of relatively small law firms).

91. On the other hand, varying profit shares among partners may increase monitoring efficiency by causing the more highly compensated partners to be monitoring specialists, while discouraging other partners from engaging in redundant monitoring. See Mathewson, *The Economics of Law Firms: A Study in the Legal Organization of the Firm*, 33 J.L. & ECON. 307 (1990) (explaining seniority-based compensation on the basis that monitoring is concentrated in senior partners). The specialization of monitoring has also been suggested as a justification for secured credit. See generally, Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982).

92. See Fama, *supra* note 76.

93. See *infra* text accompanying notes 118-20.

2. *Withdrawal Compensation*

Incentive compensation of partners includes not only periodic compensation during employment, but also compensation paid to the partner on withdrawal. In other words, from the standpoint of minimizing shirking, the payment for goodwill could be characterized as settling out any remaining incentive compensation that the partner has not already been paid. Such settling out may be necessary for one or more of several reasons. First, the firm may deliberately defer some incentive compensation until the partner has reached a certain age or tenure with the firm in order to deter withdrawal.

Second, even if the periodic payments perfectly match the partners' contributions, some withdrawal payment is necessary to settle out amounts earned since the last periodic payment. These amounts are larger the longer are the compensation periods. This particularly affects "lame duck" partners who know they will be leaving prior to the next compensation period.

Third, the problems of ascribing partner efforts to particular periods may justify a withdrawal payment that reflects expected cash flows attributable to the partner's pre-departure efforts.⁹⁴ Such efforts, including participation in management and recruitment and training of new partners, may not pay off for several years in terms of new business or higher rates. If partners are not paid on withdrawal for this expected payoff, they will have the incentive to focus on short-term payoffs for which they are compensated periodically. This particularly affects the incentives of partners who know they might soon leave the firm because, for example, they are nearing retirement. But it applies in some measure to all partners, since none can be certain how long they will continue to work for the firm.

Fourth, withdrawal payments can reduce shirking by compensating leaving partners for the difference between the value of the partner's human capital in the firm and the value outside it—that is, for the value of the partner's "firm-specific" human capital. An example might be knowledge or skills relating to the specialized business and legal problems of a particular law firm's clients. A professional who develops such skills rather than more generally marketable skills may be worth more in the firm than outside of it. This enables the firm to earn "quasi-rents" by employing the partner and not adjusting the partner's compensation to reflect firm-specific capital.⁹⁵ In the ab-

94. This form of withdrawal compensation can be characterized as assigning to partners a transferable property right in all cash flows attributable to their efforts. The withdrawing partner in effect sells this right to the continuing partners.

95. For seminal writings developing this basic concept, see O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 26-30 (1975); Klein, Crawford & Alchian, *supra* note 9. Klein, Crawford and Alchian say that law firms are formed because lawyers' work is "highly specialized to each other," so

sence of appropriately structured withdrawal compensation, the professional may forestall this potential opportunism through a form of shirking—that is, refusing to invest in efforts to create firm-specific human capital although such efforts may benefit the firm.⁹⁶

It is important to note that the conventional accounting approach to goodwill, in addition to its practical problems in terms of valuation, does not provide the sort of constraint on shirking identified in this section. Under the conventional approach, payment to a withdrawing partner is based solely on some difference between hypothetical partner compensation and total partnership cash flows.⁹⁷ In order to maximize their interests in goodwill under this method, partners would have some incentive to minimize the value of their services as long as the resulting reduction in periodic compensation was less than the expected gain in withdrawal compensation. This would provide significant perverse incentives to partners who were in their final periods before retirement, or who worked in firms that compensated periodically based on factors other than on the partners' productivity.⁹⁸

B. Risk-bearing Costs

Professionals' returns on the human capital they invest in a professional partnership are, like other investments, subject to risk. This

that the lawyers need a contract that precludes individual partners from appropriating value. *Id.* at 323 n.51. One such arrangement might include withdrawal compensation. For applications to corporate chief executives, see Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Johnson, Magee, Nagarajan & Newman, *supra* note 30.

One way a professional can avoid this problem is to be in a position to take clients along when she leaves the firm. However, these clients might become "property" of a particular firm which withdrawing lawyers cannot easily take with them. See *infra* text accompanying notes 113-15.

96. Note that this form of compensation is based on the partners' contributions to the firm's *past* earnings rather than *expected* earnings as with the other compensation forms discussed immediately above.

Compensating a partner on account of firm-specific human capital is analogous to the structuring of "golden parachute" contracts for corporate executives. These contracts commonly provide for substantial severance pay for executives displaced by takeover. Golden parachutes have been explained partly as a way of ensuring that the executives are paid for human capital contributions to the creation of firm value that have not been fully rewarded by their periodic compensation and that the employees cannot take with them when they leave the firm. The promise of this severance compensation induces the employees *ex ante* to contribute firm-specific human capital. See Knoeber, *Golden Parachutes, Shark Repellents and Hostile Tender Offers*, 76 AM. ECON. REV. 155 (1986). For discussions of takeover defenses as an alternative solution to the problem of shareholder appropriation of executives' contributions to the firm, see Coffee, *Shareholders vs. Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); Haddock, Macey & McChesney, *supra* note 95.

97. See *supra* text accompanying note 35.

98. Non-productivity-based compensation is discussed in the next section.

risk is a real cost to risk-averse partners that they would seek to minimize or be compensated for. This section will show that compensating the partners so as to minimize shirking may actually increase partners' riskbearing costs.

1. *Periodic Payments*

Compensating the partners so as to minimize shirking exposes partners to the risk that their contributions to the firm's joint product may decline because of factors beyond their control. In particular, the partners' specialty may suffer from economy-wide shifts relative to other specialties. Or a client that has produced much of the partner's contribution to the firm's income may cease operations or leave the firm for reasons wholly unrelated to the partner's effort. Thus, there may be a tension between risk-bearing and shirking costs.⁹⁹

Gilson and Mnookin have argued that profit-sharing in some large law firms is structured to reduce risk rather than to reward partners' contributions to the firm's joint product.¹⁰⁰ They point out that many large law firms pay partners a profit share based solely on their seniority in the firm.¹⁰¹ Thus, income produced by securities lawyers in a rising economy balances bankruptcy lawyers' slow times. By joining in a single firm and sharing on a seniority basis, the two types of lawyers in effect hold different specialties in a human capital portfolio. In this way they diversify away some of the risk of financial shock to their own human capital.¹⁰²

Gilson and Mnookin argue that the shirking costs of such a senior-

99. In non-professional firms the tension may be between two types of agency costs. Paying fixed salaries may increase *equity's* agency cost by reducing managers' incentives to maximize profits, but it tends to decrease *creditors'* agency costs by aligning the interests of creditors and managers. Managers on fixed salaries, like creditors, bear insolvency risk (from potential loss of firm-specific human capital investments) while not sharing in favorable results of risky strategies. But this sort of creditors' agency cost is rarely significant in professional firms because such firms ordinarily are not highly leveraged and do not adopt risky management strategies.

100. See Gilson & Mnookin, *supra* note 35.

101. While Gilson and Mnookin's discussion is based on law firms, there is no reason why it cannot be generalized to other professional firms, including accounting, advertising and investment banking, involving substantial investments of partner human capital in specific areas of expertise and a risk that changing economic conditions will devalue these investments. For an alternative explanation for seniority-based compensation, see Mathewson, *supra* note 91.

102. Gilson and Mnookin offer their theory partly as an explanation of why some law firms are larger than seems justified by economies of scale. However, as they note, human capital risk theoretically could be reduced by going public and spreading the risk among capital investors. See Gilson & Mnookin, *supra* note 35, at 329-30 n.30. The principal problem with this solution is that shirking costs probably would be very high unless the lawyers were paid something like their marginal products—either by structuring compensation within the firm or

ity-based system can be minimized other than by productivity-based profit-sharing. Shirking can be reduced to some extent through direct monitoring of hours worked¹⁰³ and by developing through training and recruitment a firm "culture" of conscientiousness.¹⁰⁴ Gilson and Mnookin reason that seniority compensation can actually reduce shirking as compared with a productivity measure because partners compensated on a seniority basis will be more likely to develop the firm's rather than their own relationships with clients.

Partners' risk is also affected by the length of the compensation periods. If partners were compensated only every few years, there might be jolting period-to-period fluctuations resulting from, among other things, changes in the value of the partners' human capital. More frequent pay periods may "smooth" these jolts.¹⁰⁵ Because partners' promotional efforts and contributions to the firm's reputation take some time to be reflected in earnings, changes in partner productivity occur slowly through successive pay periods rather than in large increments.

2. *Withdrawal Compensation*

Unlike incentive-based compensation, seniority-based periodic compensation provides no clear basis for computing the withdrawing partner's share of expected cash flows. A simple approach would be to apply the active partner's percentage to post-withdrawal expected

through "ex post settling up" in the lawyers' job market. This would lead back to the problem of undiversified human capital risk.

Some professional-type firms do go public. The practice is common in advertising and brokerage firms, and there is even a recent report of its extension to an accounting firm. *See supra* note 34. Capital contributors to these firms are compensated at least partly on the basis of returns to financial and other non-human capital. Moreover, in advertising and brokerage firms, shirking by professionals may be more observable, so that such firms may be able to constrain shirking other than through incentive compensation.

103. However, as discussed in the text accompanying note 85 above, observing hours worked is a less satisfactory way of reducing shirking as the professional's work becomes more sophisticated.

Because a strict hours-worked formula is sensitive to economic conditions, application of such a formula would reduce diversification. Gilson and Mnookin, therefore, suggest application of a system that would distinguish reduction in hours worked by shirking from that caused by changing economic conditions. *See Gilson & Mnookin, supra* note 35, at 373.

104. *Id.* at 375-79.

105. Retained earnings may increase agency costs because managers may invest undistributed cash at a lower rate of return than the partners' would have earned if the funds had been distributed. For example, managers may buy lavish office space. But this agency problem is probably lower in a professional partnership than in a publicly traded corporation because managing and non-managing partners have common interests in how the money is invested, and because partners are involved more directly in management than are public corporation shareholders.

cash flows. However, the active partner's percentage obviously is predicated on her contribution of effort which is now being withdrawn.

Second, a possible alternative would be to shift to an incentive approach in computing withdrawal compensation. However, this might let partners renege on the sharing bargain by withdrawing, or forcing renegotiation by threatening to withdraw, when their current success would yield a high withdrawal payment. If, on the other hand, the partner must withdraw during a down-swing in the partner's professional fortunes, this raises the risk-bearing problem discussed immediately below.

Third, withdrawing partners could be denied any interest in expected cash flows. The problem with this approach is that it would increase risk-bearing costs because partners would bear not only those risks associated with variability in the firm's income, but also those connected with withdrawal. Partners who are compensated on a seniority basis have, at any given time, interests in the firm's expected earnings that include profits attributable to the other partners' efforts. In exchange for this interest they have foregone earnings based on their own efforts. Since there is no public market for this interest, without withdrawal compensation the interests are forfeited on withdrawal.

Making partners' rights contingent on non-withdrawal resembles subjecting the partners to the risk of a coin-flip. As with a coin-flip, the partners do not know and cannot control (1) when they will die; (2) when exigencies will force them to withdraw unexpectedly before death; or (3) when remaining in the firm will become costly because another use of the professional's human capital becomes more valuable on account of misconduct by or conflict with the other partners.¹⁰⁶ If a partner loses the coin-flip, the other partners "win" the profit share that otherwise would have been paid to the losing partner.¹⁰⁷ Assuming all of the partners must go through these periodic coin-flips, their *expected returns* are the same as if they did not engage in this

106. See Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U.L.Q. 357, 380-83 (1987)(discussing these and other costs of partner illiquidity). A partner may remain in the firm despite these costs if the costs are less than the expected value of future payoffs from remaining with the firm.

107. An analogy is a "tontine" in which the last living participant takes the "pot." For example, in *Shields v. Shields*, 498 A.2d 161 (Del. Ch. 1985), a share transfer agreement permitted the parties to buy the stock of any other party who wished to sell for the amount offered by a third party, or for book value in the absence of a third-party offer, and to buy the stock of a deceased shareholder for book value. Because book value was only one-sixteenth of market value, and because there was no real market for the stock, the agreement was, as the court said, a "lottery" won by the longer-lived shareholders. The court interpreted the agreement very restrictively, effectively allowing one side to cancel it unilaterally.

game. But the game increases the *variance* of returns, since the players now have some possible zero outcomes. The partners would demand to be paid to participate in this risky game. If there is no offsetting benefit to the partners, the game will increase the firm's operating costs.¹⁰⁸

A fourth approach to withdrawal compensation under a seniority sharing approach would be to provide for a level of withdrawal compensation that is either fixed or determinable through a formula. This amount, like periodic compensation, could increase with seniority. This approach may be the best way of resolving the problems presented by the other approaches discussed above. However, it is obviously unsuitable as a default rule because the appropriate payment or formula varies among firms.

In short, compensation based on seniority, while it may solve a risk-bearing problem with incentive compensation, creates significant difficulties in designing the appropriate level of withdrawal compensation.

C. Administrative Costs

In determining the appropriate method of compensating partners, it is important to consider the costs of administering the various methods. This section will show that the high administrative costs of applying an incentive-based system may offset the benefits of such a system in constraining shirking.

1. Periodic Compensation

To apply the incentive approach discussed in section A it is necessary to determine each partner's contribution to the firm's cash flows. This is an extremely difficult task. Relatively objective measures such as number of clients originated by a partner or billable hours provide only very rough approximations because the value of a partner's work is important, and because partners contribute in various ways to the firm's reputation.¹⁰⁹ Yet to make a precise determination the partners must expend substantial resources to acquire information concerning the partners' contributions to the firm.

Because of the difficulty of determining partners' contributions to the firm's earnings, the results are subject to uncertainty, which encourages dispute and litigation. Moreover, the costs of each litigated or arbitrated case are likely to be relatively high, since precise deter-

108. Similarly, inside information has been criticized as a risky, and therefore perhaps not particularly valuable, form of executive compensation. See Easterbrook, *Secret Agents, Evidentiary Privileges and the Production of Information*, 1981 SUP. CT. REV. 309, 332.

109. See *supra* text accompanying notes 86-87.

mination of the partners' contributions requires a costly examination of the basis of the firm's earnings and testimony by experts on valuation.¹¹⁰

2. *Withdrawal Compensation*

The administrative costs of paying withdrawal compensation on an incentive basis are likely to be even greater than those of periodic compensation because of the greater difficulty of determining the appropriate level of incentive withdrawal pay.

Withdrawal pay reduces shirking if it compensates partners for cash flows expected to be produced by the withdrawing partner's human capital investment.¹¹¹ This amount includes profits attributable to the partner on individual projects or cases, as where the partner contributed research or innovative legal theories to legal cases, irrespective of how this business originated. It also includes profits earned from clients brought into the firm by the withdrawing partner's direct efforts or because of the effect of her reputation. The partner's indirect effect on partnership business obviously is difficult to isolate. Moreover, the firm must separate out business that the withdrawing partner originated but can take with her if she is not subject to a noncompetition agreement.¹¹² This may be difficult to determine at the point of withdrawal, before it is clear whether the withdrawing partner or the firm will win the competition for the client's business.

After the firm has attributed certain categories of revenues to a particular partner, it must compute the precise portion of the fee to be credited to the withdrawing partner. This includes an allocation of

110. For discussions of other areas in which clear rules may be appropriate for similar reasons, see Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 699 (1984) (mandatory disclosure rules may be preferable to common law fraud regime because of uncertain application of fraud rules); Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 114-16 (1989) (stating that attempts to determine managers' duties on a case-by-case basis by means of a broad fiduciary duty rule may be costly).

111. See *supra* text accompanying note 94. Shirking is also reduced by compensating partners for developing firm-specific human capital. See *supra* text accompanying notes 95-96. Computation of this amount presents additional difficulties. Perhaps the firm could make up the difference between the partner's expected compensation in the firm and her highest expected compensation outside the firm. But the entire difference is probably not attributable to firm-specific human capital. Indeed, compensation in the partner's present firm may simply not have been adjusted to reflect the partner's reduced abilities. Compensating partners for the difference between their pay in and outside the firm would eliminate the possibility of resolving this problem through ex post settling up in the market for professional services.

112. The partner's ability to take clients is discussed further in the text accompanying notes 113-14 below.

the fee between the partner who brought in the business and the partners who did the work, and between the partner who began a case and the partners who completed it. To illustrate the difficulty, a withdrawing legal partner may have developed an innovative theory in a case, but the case might have been won on other grounds.

The problems just discussed of separating out the withdrawer's human capital contributions to the firm's expected earnings are in addition to those of capitalizing the cash flows of the firm as a whole, or cash flows attributable to particular clients or cases. These problems are considerable, since it is impossible to predict precisely how long a client will remain with the firm, or what fees will be generated by particular clients and projects or cases.

Although it is likely to be very costly to value the withdrawing partner's property right in expected cash flows under an incentive-based approach, the partners might want to assign a positive value to this right as a constraint on shirking. The partners might choose a formula—for example, a multiple of the withdrawing partner's most recent periodic distribution—that approximates this value. But such a formula may be unsuitable as a default term since the appropriate formula varies among firms. Thus, the court may have to deny withdrawal compensation in the absence of an explicit agreement even if it concludes that such compensation might have substantial benefits, such as deterring partner shirking.

D. Opportunism Costs

A compensation system that minimizes the other costs discussed above nevertheless may be inappropriate because it increases opportunistic conduct by withdrawing or continuing partners.

1. *Periodic Payments*

Because of risk-bearing and administrative costs, professionals may agree to a compensation formula that does not reflect accurately the partners' contributions to the firm's product even if this encourages some shirking. However, partners who have benefitted under this formula at the expense of their co-partners by being paid more than they contributed to the firm might, as soon as the situation reverses, refuse to share their own contributions with their co-partners. For example, a lawyer whose specialty is out of favor may share in bounty produced by partners whose services are more in demand. When the economy changes the lawyer may leave the firm with valuable clients or jump to a firm that is willing to pay the partner based on the value of her contribution to the new firm.

Gilson and Mnookin have argued that professional firms can reduce partner opportunism by ensuring that client relationships cannot

be controlled by particular partners.¹¹³ They can, for example, offer quality assurances to clients that competitors or individual partners cannot readily duplicate. Client relationships become firm-specific in the sense that the client incurs costs if it moves to another lawyer or firm. This approach to client relations makes the partners' human capital firm-specific to the extent that the partners have developed skills uniquely valuable to the clients that are specialized to the firm.¹¹⁴ These firm-based client relationships, in turn, ensure that partners will not try to renege on the sharing bargain by leaving the firm with clients in tow.

This analysis is incomplete, however, because it does not explain fully why the partners would choose to create firm-specific capital. Gilson and Mnookin argue that seniority-based compensation encourages development of firm-based client relationships by reducing professionals' incentive to develop personal clients and their own reputations.¹¹⁵ But even under seniority-based compensation, professionals have the incentive to build their own client bases in order to ensure the mobility of their human capital. The next subsection considers whether this incentive can be reduced through withdrawal compensation.

2. *Withdrawal Compensation*

Withdrawal compensation should be designed in light of the potential for opportunistic conduct both against and by withdrawing partners.

As to opportunism against withdrawing partners, the principal problem concerns partners who have developed human capital that is more valuable in the firm (that is, in connection with the firm's clients) than it is outside the firm. Unless the partner is compensated for this investment in firm-specific human capital, the other partners can exploit the differential and pay the partner only enough to top the competitive wage. The partner may decline to develop this sort of specialized expertise in order to avoid being exposed to the risk of opportunism.¹¹⁶ One way to encourage partners to develop firm-specific capital is to promise to compensate them on withdrawal for their specialized expertise.¹¹⁷

There is also a risk of opportunistic conduct by withdrawing partners. Partners may be able to take with them not only their own human capital but also the product of the other partners' contribu-

113. See Gilson & Mnookin, *supra* note 35, at 355-66.

114. See *id.* at 370-71.

115. *Id.* at 370.

116. See *supra* text accompanying notes 95-96.

117. For a discussion of administrative costs connected with such payments, see note 111 above.

tions. The other partners may have made asset-specific investments in client relationships and work-in-process that are controlled by the withdrawing partners.¹¹⁸ For example, a withdrawing law partner who takes the firm's clients also takes uncompleted cases or other work for which the fee will accrue only after the withdrawal.¹¹⁹ The fee may be determined by the final result, which is the product of work by the other partners. Less directly, the firm may have paid the withdrawing partners their profit shares and provided staff and other support during an otherwise unproductive period while they worked on the case.¹²⁰ The opportunity to take such assets may, in fact, encourage partners to develop personal client relationships even if they are promised compensation on withdrawal for firm-specific human capital.

Not paying withdrawing partners on account of expected earnings is one way to discourage or offset withdrawal of assets owned by the other partners. The problem is that such denial of compensation may significantly increase shirking and risk-bearing costs.¹²¹ To minimize the total of all these costs, the agreement could provide for compensation only in situations where there is little risk of opportunism by the withdrawing partner, as on withdrawal by death or by expulsion without fault of the expelled partner.

E. Conclusions Concerning the Appropriate Default Rule

The above analysis supports the current legal rule that denies withdrawing professional partners a share of expected post-withdrawal earnings. Although such withdrawal compensation can help minimize shirking, risk-bearing and opportunism against withdrawing partners, it is difficult to design a default rule that accomplishes these objectives without imposing prohibitive administrative costs and encouraging opportunism by withdrawing partners.¹²²

On the other hand, it may be feasible to provide for a limited property right in post-withdrawal earnings that better optimizes the total of shirking, administrative costs and opportunism than completely denying such an interest. The courts have in effect adopted such a com-

118. Devices for weakening this control by individual partners are discussed above in the text accompanying notes 113-14.

119. For a classic example of this sort of case, see *Rosenfeld, Meyer & Susman v. Cohen*, 146 Cal. App. 3d 200, 194 Cal. Rptr. 180 (1983), in which the leaving law partners took with them a major antitrust case.

120. This appears to have been the situation in *Rosenfeld, Meyer & Susman*.

121. See *supra* subsections III.A.2 & III.B.2.

122. Indeed, the partners may want to deny withdrawal payments on account of tangible assets or non-goodwill intangibles in order to deter opportunistic withdrawal. For a case in which a withdrawing partner was denied an interest in a patent for this reason, see *Pav-Saver Corp. v. Vasso Corp.*, 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986).

promise by permitting compensation of withdrawing professional partners for work that was "in process" prior to the withdrawal on the same basis as the partners would have been paid if the proceeds had been received prior to the withdrawal.¹²³ The work-in-process rule seems inconsistent with the general rule denying withdrawing partners a property right in goodwill. But the rule makes sense in light of the factors discussed in Part III.

First, giving partners property interests in work-in-process minimizes shirking and risk-bearing costs. All of the partners may have invested human capital in work-in-process that was not reflected in their periodic compensation. If the partners know they will be denied compensation on these projects if they leave or if withdrawing co-partners take the cases with them, they may concentrate their efforts on shorter-term projects or cases for which compensation is likely to be kept current. Moreover, the departure contingency increases the riskiness of partners' compensation.

The aspect of the work-in-process rule that denies extra compensation to partners who complete the work¹²⁴ is more troubling because it would seem to encourage shirking by these partners *vis-a-vis* the clients whose cases they are completing.¹²⁵ But awarding a fee to the completing partners on an hours-worked basis may simply replace one incentive problem with another by devaluing earlier important contributions by the other partners. Moreover, potential shirking is limited in this context by the fact that partners have the incentive to protect their general reputations and continuing relationships with the clients.¹²⁶

The work-in-process rule resolves the problems of computing the value of the partners' contributions¹²⁷ by applying the formula the partners themselves devised to compensate for their contributions to the going firm. Thus, the shirking and risk-bearing benefits of compensating for work-in-process are not offset by administrative costs. Nor are the benefits of compensation for work-in-process offset by opportunism costs. On the contrary, the work-in-process rule blocks

123. See *supra* text accompanying notes 55-56.

124. See *supra* text accompanying note 56.

125. See Hillman, *Law Firms and Their Partners: The Law & Ethics of Grabbing and Leaving*, 67 TEX. L. REV. 1, 17, 49-50, 57 (1988); Comment, *Barefoot Shoemakers: An Uncompromising Approach to Policing the Morals of the Marketplace When Law Firms Split Up*, 19 ARIZ. ST. L.J. 509 (1987).

126. See *Meehan v. Shaughnessy*, 404 Mass. 419, 535 N.E.2d 1255 (1989); 2 BROMBERG & RIBSTEIN, *supra* note 10, § 7.08(e), at 7:85. Professionals, such as attorneys, also may be constrained by ethical and fiduciary duties. See *Jewel v. Boxer*, 151 Cal. App. 3d 171, 199 Cal. Rptr. 273, *vacated*, 156 Cal. App. 3d 178, 203 Cal. Rptr. 13 (1984).

127. See *supra* subsection III.C.2. For a case rejecting a fee based on an attempted calculation of the value of the partners' contributions, see *Jewel v. Boxer*, 151 Cal. App. 3d 171, 199 Cal. Rptr. 13 (1984).

withdrawing partners who control cases from appropriating the benefits of work done on these cases by other partners.¹²⁸

Although the work-in-process rule is a suitable standard form, it does not operate perfectly in all firms. The partners may wish to contract around the rule, as where they can devise a formula that more precisely compensates for partner contributions to work-in-process.¹²⁹

F. Opting Out of the Standard Form: Ethical Constraints

As indicated by the foregoing discussion of the work-in-process rule, withdrawal compensation reflecting the partners' contributions to the firm may be an appropriate term if the parties can avoid excessive administrative and opportunism costs. However, agreements providing for such compensation have been held unenforceable in law partnerships because of the ethical ban on fee-splitting.¹³⁰

The justifications that have been suggested for the anti-fee-splitting rule are unconvincing. First, it has been said that fee-splitting gives referring lawyers the perverse incentive to refer to the highest bidder rather than in the client's interest.¹³¹ But this argument ignores the perverse incentives that practitioners have without fee-splitting to retain work they are not fully equipped to handle.¹³²

128. Opportunistic conduct by withdrawing partners is discussed in the text accompanying notes 118-20 above.

129. For a case enforcing such an agreed formula, see *Meehan v. Shaughnessy*, 404 Mass. 419, 535 N.E.2d 1255 (1989) (withdrawing partner could remove any matter he brought to the firm with client consent and payment to firm of "fair charge" for its services and expenses).

130. For the ethical rules specifying the conditions under which lawyers in different firms may share fees, see MODEL CODE, *supra* note 10, DR 2-107(A); MODEL RULES, *supra* note 10, Rule 1.5(e). For cases holding unenforceable on ethical grounds agreements providing for post-dissolution fee-sharing, see *Corti v. Fleisher*, 93 Ill. App. 3d 517, 417 N.E.2d 764 (1981); *In re Silverberg*, 75 A.D.2d 817, 427 N.Y.S.2d 480 (1980). See also *Geffen v. Moss*, 53 Cal. App. 3d 215, 125 Cal. Rptr. 687 (1975) (sale of law practice unenforceable); *O'Hara v. Ahlgren, Blumenfeld & Kempster*, 127 Ill. 2d 333, 537 N.E.2d 730 (1989) (voiding contract to pay deceased attorney's wife for sale of practice). Some cases have denied withdrawing attorneys an interest in goodwill in the absence of an agreement partly on ethical grounds. See *Bump v. Stewart, Wimer & Bump, P.C.*, 336 N.W.2d 731 (Iowa 1983); *Siddal v. Keating*, 8 A.D.2d 44, 185 N.Y.S.2d 630 (N.Y. App. Div.), *aff'd*, 7 N.Y.2d 846, 196 N.Y.S.2d 986, 164 N.E.2d 860 (1959). Cf. *Fraser v. Bogucki*, 203 Cal. App. 3d 604, 250 Cal. Rptr. 41 (1988) (holding, partly on basis of ethical fee-splitting rule, that attorney had no cause of action against former partners on grounds they appropriated client relationships).

131. See *Geffen v. Moss*, 53 Cal. App. 3d 215, 125 Cal. Rptr. 687 (1975); *Corti v. Fleisher*, 93 Ill. App. 3d 517, 417 N.E.2d 764 (1981). Cf. *O'Hara v. Ahlgren, Blumenfeld & Kempster*, 127 Ill. 2d 333, 537 N.E.2d 730 (1989) (rule against fee sharing with non-attorney, here, deceased attorney's wife who sold practice, would give layperson perverse incentive to recommend buyer of practice).

132. See C. WOLFRAM, MODERN LEGAL ETHICS § 9.2, at 510-11 (1986); Pauly, *The Ethics and Economics of Kickbacks and Fee Splitting*, 10 BELL J. ECON. 344 (1979).

A second justification for the ban is that fee-splitting hurts the legal profession by encouraging lawyers to act as commercial brokers rather than legal professionals.¹³³ This rationale helps explain why ethical rules do not allow fee-splitting even with the client's consent. But it is not clear that concern for the reputation of the legal profession, independent of clients' interests, justifies non-enforcement of lawyers' agreements.

A third argument is that fee-sharing leaves lawyers without adequate incentives to do the work properly.¹³⁴ But there is no reason to assume that the referee is left with so little compensation that there is an incentive to shirk. Referees will not pay fees so high as to reduce their net compensation below their marginal cost of rendering the service.¹³⁵ While they may attempt to reduce their marginal cost by expending less effort, they always have some incentive to do this in order to maximize profit if the client cannot easily detect the shirking. Indeed, the fact that the professional is working on referral may warn the client to be watchful, making shirking more difficult.

Even if the fee-splitting prohibition is justified in some circumstances, it plainly should not be applied to bar compensation to withdrawing partners.¹³⁶ There is no more danger of perverse referrals from payments to a withdrawing partner than there is from payments of a share of the profits to continuing partners.¹³⁷ And payments to withdrawing partners hardly commercialize law practice any more than does sharing in the going firm.

Most importantly, the analysis in this Article demonstrates that payments to withdrawing partners cannot be condemned on the ground that they promote shirking. On the contrary, the payment is best characterized as delayed compensation for the partner's past contribution to the firm,¹³⁸ which actually reduces shirking by partners while they are associated with the firm.¹³⁹ Thus, there is no ethical

133. See *Corti v. Fleisher*, 93 Ill. App. 3d 517, 417 N.E.2d 764 (1981).

134. See *O'Hara v. Ahlgren, Blumenfeld & Kempster*, 127 Ill. 2d 333, 537 N.E.2d 730 (1989); *Corti v. Fleisher*, 93 Ill. App. 3d 517, 417 N.E.2d 764 (1981).

135. See Pauly, *supra* note 132.

136. This is recognized by DR 2-107(B) of the *Model Code* which permits "payment to a former partner or associate pursuant to a separation or retirement agreement." See *Corti v. Fleisher*, 93 Ill. App. 3d 517, 417 N.E.2d 764 (1981) (exception justifies compensation to retiring partner even if not strictly based on services rendered, but exception not applicable under facts of the case); *Spayd v. Turner, Granzow & Hollerkamp*, 19 Ohio St. 3d 55, 482 N.E.2d 1232 (1985) (exception would permit payment on account of goodwill to former partner, but such payment precluded by contract). See also ABA Comm. on Ethics and Professional Responsibility Formal Op. 327 (1971) (permitting payments to deceased partners' estates).

137. Indeed, the formation of firms has been explained as a way around the anti-fee-splitting rule. See Pauly, *supra* note 132, at 351.

138. See *supra* text accompanying note 94.

139. Moreover, since the payment to the retired partner relates to the partnership's

reason not to enforce contracts providing for goodwill payments to withdrawing partners.

IV. DISTRIBUTIONS IN MARITAL DISSOLUTIONS

Many courts have let divorced spouses share in professional partnership goodwill, even to the extent that this includes the partners' personal goodwill¹⁴⁰ and even if the agreement denies the partner herself withdrawal compensation on account of goodwill.¹⁴¹ This is inconsistent both with the conventional definition of partnership goodwill and with the narrower rule applied in partner withdrawal cases. It is also inconsistent with the rule that a professional's earning capacity is not properly considered marital property.¹⁴²

Perhaps permitting the non-partner spouse to be paid for "goodwill" of professional partnerships is a way around the rule that a professional's earning capacity is not properly considered marital property. Characterizing the payment as goodwill of the *partnership* avoids the appearance that it represents future earning capacity of the *partner*. This approach should be subject to policies relating to marital awards. For example, the courts could decide that a non-partner spouse who delayed consumption during the early years of his spouse's career is entitled to share in the fruits of that career in the form of expected income from the partnership.¹⁴³ The same reasoning might

entire caseload, it does not encourage shirking on particular cases as might the payment of a referral fee. See *O'Hara v. Ahlgren, Blumenfeld & Kempster*, 127 Ill. 2d 333, 537 N.E.2d 730 (1989) (distinguishing on this ground payments to deceased law partners from fee-sharing with lay person in connection with sale of law practice).

140. See *supra* text accompanying notes 63-74.

141. See *supra* note 74 and accompanying text.

142. See *Aufmuth v. Aufmuth*, 89 Cal. App. 3d 446, 152 Cal. Rptr. 668 (1979), *overruled on other grounds*, 27 Cal. 3d 808, 614 P.2d 285, 166 Cal. Rptr. 853 (1980); *In re Marriage of Graham*, 194 Colo. 429, 574 P.2d 75 (1978); *Mahoney v. Mahoney*, 91 N.J. 488, 453 A.2d 527 (1982); *Frausto v. Frausto*, 611 S.W.2d 656 (Tex. Civ. App. 1981); *DeWitt v. DeWitt*, 98 Wis. 2d 44, 296 N.W.2d 761 (Ct. App. 1980). But see *O'Brien v. O'Brien*, 66 N.Y.2d 576, 498 N.Y.S.2d 743, 489 N.E.2d 712 (1985).

Some courts have provided for something like a property right in the professional degree by permitting reimbursement of the non-professional spouse in certain situations for contributions toward the other spouse's professional degree. See *Sullivan v. Sullivan*, 37 Cal. 3d 762, 209 Cal. Rptr. 354, 691 P.2d 1020 (1984) (applying statute); *In re Marriage of Francis*, 442 N.W.2d 59 (Iowa 1989); *Daniels v. Daniels*, 165 Mich. App. 726, 418 N.W.2d 924 (1988); *Peterson v. Petersen*, 737 P.2d 237 (Utah App. 1987). See generally Annotation, *Spouse's Professional Degree of License as Marital Property for Purposes of Alimony, Support, or Property Settlement*, 4 A.L.R.4th 1294 (1981).

143. For authorities supporting recognizing the contributions of non-partner spouses to partner human capital, see *Ford v. Ford*, 782 P.2d 1304 (Nev. 1989); *Parkman*, *supra* note 7, at 222. This is similar to the rule giving the non-professional spouse a reimbursement-based property right in a professional degree. See *supra* note 142.

justify a different result when the divorce comes later in the partner's career.

Detailed analysis of this point is beyond the scope of this Article. For present purposes it is enough to point out that this justification rests on considerations relating only to the marital dissolution context. Both the accounting definition of "goodwill" and the partner withdrawal cases are beside the point. Indeed, erroneously putting the question in terms of partnership goodwill is misleading if the court is really awarding recovery based on the spouse's contributions to the partner's own human capital. The result of this reasoning is illogically to exclude the same contributions to non-partner reputations.¹⁴⁴

As different considerations are relevant in the divorce cases, so the considerations weighing against recognition of partner goodwill in the withdrawal cases are irrelevant in the divorce context. Since recognizing partner goodwill in the divorce context does not result in a payment to the partner, it does not encourage opportunistic withdrawal. Nor are the administrative costs of recognizing partner goodwill prohibitive once the courts are willing to accept the artificial "excess earnings" approach to valuing this asset.¹⁴⁵

Similar reasons justify ignoring limitations on withdrawal compensation in the partnership agreement for purposes of determining marital awards. The courts sometimes say that the agreement should not control because it only applies to withdrawal,¹⁴⁶ without fully explaining why the two situations should be distinguished. The reason is that limitations in the agreement may be designed to reduce costly disputes among the partners at withdrawal time, or to deter opportunism by withdrawing partners.¹⁴⁷ That is why the amount may not fully reflect the "value" of the interest. The problem is not one of valuation, but of determining the parties' underlying rights.

On the other hand, some considerations that are relevant in the divorce context do militate against recognizing partner goodwill. Irrespective of how the spouse's right is characterized, recognizing the right causes the partner spouse to make payments without having received money or marketable assets from the partnership. Moreover, the courts could decide that it is so costly to determine the value of such a speculative asset that valuation should be left to formulas in ante-nuptial agreements.¹⁴⁸ In short, the question is not one of valua-

144. See Parkman, *supra* note 7, at 221-22.

145. See *supra* text accompanying note 65.

146. See cases cited *supra* note 74.

147. Some cases have said that the spouse's interest in the partnership goodwill is analogous to his interest in an employee's deferred compensation. See Mitchell v. Mitchell, 152 Ariz. 317, 732 P.2d 208 (1987); Sorenson v. Sorenson, 769 P.2d 820 (Utah 1989). But it is precisely because the interest being awarded to the spouse is *unlike* deferred compensation that the spouse may be entitled to it.

148. See Mahoney v. Mahoney, 91 N.J. 488, 497, 453 A.2d 527, 532 (1982) ("Valuing a

tion or accounting in the abstract, but of the rights of particular parties in a particular situation.

V. CONCLUSION

The rules regarding the goodwill of professional partnerships are better understood from the standpoint of policies governing payments to withdrawing partners and partners' spouses than as a matter of the accounting concept of goodwill.

As an accounting concept, "goodwill" is virtually impossible to value in the professional firm because of the daunting problems inherent in finding a comparable market valuation and in determining a capitalized earnings value. Moreover, the accounting meaning of goodwill does not explain the different results in the withdrawal and divorce cases. If goodwill is an asset of professional firms, it should be equally so for withdrawing partners and for partners' spouses.

The different legal results do make sense in the light of economic analysis of partner compensation. From this perspective, the partner withdrawal cases can be understood as a default legal rule that balances the costs and benefits of compensating withdrawing professional partners. Although compensating these partners on the basis of the firm's expected earnings might minimize shirking, such compensation might involve prohibitive administrative, risk-bearing and opportunism costs. The courts have in fact balanced these various kinds of costs by permitting compensation for work-in-process. On the other hand, wholly different considerations apply to payments to partners' spouses in marital dissolutions.

More generally, this Article demonstrates that issues concerning partners' rights that appear to depend on principles of accounting and valuation really are better analyzed in the light of modern economic theories of the firm.

professional degree in the hands of any particular individual at the start of his or her career would involve a gamut of calculations that reduces to little more than guesswork.").